Benchmark Bonds Programme – A Bonds' Market Development Initiative

Commentary by Cappitus Chironga of Monetary Operations and Debt Management

In September 2007, the Central Bank of Kenya embarked on an initiative to issue benchmark bonds to address the fragmentation problem. The Bank in consultation with Treasury and Market Leaders Forum adopted 2, 5, 10, 15 and 20-year bonds to form benchmark issues. To implement this programme, a number of strategies such as reopening, switching, bond conversion as well as reissuing some maturities were identified. **Benchmark bonds** are large-sized, frequently traded papers at stable prices with their yields being used to derive benchmark yield curve which is used as reference points for pricing other instruments or facilities.

Bond reopening is a standard practice in many developed and emerging markets that is used to address the bond market fragmentation problem. Bond fragmentation refers to the existence of too many small outstanding bonds scattered everywhere in the secondary market. This scenario leads to illiquid and sometimes volatile bond market, more often resulting into a distorted yield curve. This is because the liquidity around such instruments is held by a few investors who may be speculators or are pursuing buy-and-hold strategies, the latter case applying to pension funds. In addition, fragmentation makes it difficult for both the issuer and investors to plan their portfolios in terms of redemptions structure, interest payments schedule and investment decisions. Bond market fragmentation, therefore, has negative impact on both Primary and Secondary Market development. This is important for managing large redemptions in the absence of a sinking fund.

Switching strategy is where a portion of an existing bond is switched through an auction process into another existing bond preferably of longer maturity or a new one to build the volume of the benchmark issue. In such a case, the price of the source bond may be fixed and investors only bid in auction the price of the target bond. The issuer however decides how much to accept up to the preannounced maximum amount. It is a voluntary exercise, but the Government may buyback holders not willing to switch their stock into a consolidated one. However to ensure market confidence, such options should be provided in the prospectus.

Bond conversion strategy is where the outstanding volume of the bond is redeemed / converted into another/a new one preferably with longer maturity provided the holders of such a portion are agreeable. Conversion normally requires an offer price ratio usually determined against the current yield curve. The issuer offers Ksh W per 100 face value of the source bond to be converted into Ksh X per 100 face value of the target (new) bond. The offer is left open for a period of time to allow investors to undertake conversion. The issuer may choose to pay off any residual amounts for those investors not willing to take the option.

Bonds Re-issue strategy refers to where bonds of similar maturities are issued in the market repeatedly, but has different maturity date, may differ in the volume and even the coupon

rate. This strategy only solves the big-redemption problem but not the fragmentation problem as there may still exist many bonds in the market depending on issuance frequency and sizes.

Bond reopening involves opening up/offering the same paper to the primary market on a date other than its original issue date with a view to increasing its outstanding amounts and/or expanding the original offer amounts. The instruments maintain the same features except for the new issue date as well as the offer price or yield which rely on the prevailing secondary market yield and time remaining to maturity. When the bond is reopened on a value date that coincides with interest/coupon payment date, settlement/offer payment price equals to the clean price. However, if reopening value date falls on a date other than coupon date, settlement/offer price will include accrued interest, hence dirty price. This is very important for the issuer in terms of borrowing costs minimization, to the market in terms of yield curve computation and to the Kenya Revenue Authority in terms of tax computation. The CBK adopted reopening as its first strategy to implement its Benchmark Bonds Programme because it does not have immediate budgetary implications compared to buybacks and it was popular among Market Leaders membership. The success in the market has exceeded expectations.

The Success of the first reopening of Treasury Bond Issue FXD4/2008/5 on 27th April, 2009 was a milestone in the country's bond market development initiatives. The bond, with coupon rate of 9.5%, was first issued on 27 October, 2008 with total value of Ksh 7.0 bn, but only Ksh 4.4 bn was taken. By reopening this issue, the consolidated volume rose to Ksh 10.01bn at face value, thus creating adequate liquidity for secondary market trading. Building on this success, the Bank reopened FXD3/2007/15 in May 2009 whose volume rose from Ksh 7.8bn to Ksh 18bn and in June 2009, FXD1/2008/20 was reopened, raising the outstanding volume from Ksh 1.9bn to 9.5bn.

The outcome of this reopening exercise has been reduced cost of issuance, popular among investors, increased secondary trading turnover, stable yield curve and even declining yields from original auctions. This will continue into the Fiscal Year 2009/2010 to ensure the benchmark bond programme already entrenched in the Medium Term Debt Strategy (MTDS) of the Treasury is successful. The Bank's ultimate goal is to have very few but very large bonds in the market to spur trading, a key indicator of bond market deepening. The challenge however remains on managing large redemptions in the absence of a sinking fund!

The writer can be reached on Tel: 2863634 for any detailed clarification.